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Tuesday, June 24, 2008

Commodity hysteria -- an overview

Congress is going crazy over commodities, and especially over oil. They are convinced that we have a commodities bubble, so that all they have to do is smash down their boogymen, "the speculators", and all will be hunky dory. They are convinced of this because those supply/demand curves in the first chapter of our Econ 101 textbook no longer seem to be working for commodities.

This article provides an overview of the state of the commodities markets -- follow the links for more explanation of the various topics.

Those supply/demand curves in the first chapter of your Econ 101 textbook assumed that goods are sold for some fix standard of value, a currency. But under floating currencies, which the world has had since the U.S. went off gold in 1970, there is no fixed standard of value. When trading commodities, supply and demand for the *currencies* they are traded for must now be taken into account. A long commodity position is also a short currency position, and vice versa. Furthermore, *expectations* about *future* supply and demand for currencies must be accounted for. Under floating currencies and a free market in commodities, commodity prices, especially for commodities like oil and gold where the stockpile (whether below or above ground) to production ratio is very high and storage costs low, are highly volatile – a small change in inflation expectations causes a very large change in commodity prices. The commodities themselves start to act like gold: to take on monetary functions such as a store of value or a hedge for currency-denominated debt. The logical emergence of money from barter is taking place every day as commodities come to serve these monetary functions better than floating currencies.

The critics complain that commodities markets, no longer reflecting Econ 101 supply and demand, are no longer providing reliable price signals. In fact commodity prices still are reflecting Econ 101 supply and demand, but this often tends to get buried in the noise of the much larger price changes caused by changes in inflation expectations. The fault lies with poorly managed floating currencies, not with attempts by currencies users to protect against the damage done by floating currencies, for example by hedging their dollar-denominated investment portfolios with long commodity positions. Trying to stop "speculation" will be like curing a fever by attacking the immune system. You may get rid of the fever, but you won't get rid of the flu, and the patient, no longer protected, may end up six feet under.

The evidence for all this, such as the great rise in the use of commodity derivatives and commodity index ETFs (exchange-traded funds) and ETNs (exchange-traded notes) by long-term investors such as pension funds, endowments, and sovereign wealth funds, in parallel the great recent rises in commodity prices, are lumped by critics under their derogatory label of "speculation." Another, and probably even larger, source of the oil run-up are decisions by producers to keep oil in the ground (where its storage costs are cheapest) rather than pump it only to sell it for depreciating dollars. Similarly, there has been a great deal of informal "hoarding" of food. Here the

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commodity is being stored by those who expect to consume, or who expect their customers to consume, the commodity in the future. The stockpile is a hedge against both the falling currencies and political risk that governments might hoard and ration the food. This "tacit speculation" too reflects an increase in inflation expectations. If or when inflation expectations decrease, we can expect (contrary to "peak oil" theory) oil pumping to greatly increase, as having dollars will once again become more valuable than having oil in the ground, and we can expect informal food stockpiles to be drawn down and food prices to drop.

These are all attempts to preserve wealth in the face of a highly uncertain, and probably falling, value of the future dollar and other floating currencies. In the era of floating currencies, not only are commodities a legitimate asset class, they are an essential asset class. Floating currencies add a very large and dominating amount of noise to commodity price signals when inflation expectations change, but there is no easy fix for this problem.

Attacks against commodity "speculation" are attacks against efforts to protect property and markets against highly uncertain currencies. Without this protection, economies will be in grave danger of wealth destruction. Instead of attacking "speculation", the great increase in trade of "paper barrels" or "video barrels" should be encouraged. The more commodities can be traded as bits instead of by shipping physical commodities, the lower the transaction costs that will be imposed on tradition physical delivery markets. The "rolling-over" of commodities futures -- when expiring futures are swapped for distant futures instead of taking delivery of the physical commodity -- should be formalized in long-term commodities securities that minimally disrupt traditional "commercial" commodity hedging operations.

We may be seeing only the first stages of a switch from floating currencies, which may be proving to be unworkable, to commodity-backed currencies. Floating currencies were and are a great historical experiment, and there is no guarantee that such experiments will work out in the long run. By serving monetary functions such as stores of value and hedges against currency-denominated debt, commodity index ETFs and ETNs are starting to serve as monetary substitutes. But the benefits so far have been limited to investors and other big players. Those saving for retirement or who will have to pay for their child's education are benefitting from the use of commodity long positions to stablize pension and endowment funds against falling currencies and protect them against future inflation. But we still have to take our wages in floating currencies, hold our checking and savings accounts in floating currencies, and pay or be paid our debts in floating currencies. Can commodity money move from Wall Street to Main Street?

There are, alas, great legal barriers to retail commodity money. While legal barriers often just increase costs by a few basis points for Wall Street, they usually prove insuperable for the man in the street. To remove these legal barriers, contracts in any part of the economy should be allowed to use commodity index ETFs or other standards of choice as payment terms. Negotiable instruments law in the U.S. must be changed to allow payments by check, money order, etc. in commodity standards to compete against government currencies on a level playing field. Legal tender laws requiring an option to pay debts in particular currencies should be eliminated in order to allow payment terms denominated in commodity indices to be as simple as payment terms denominated in dollars. These kinds of reforms will bring the benefits of stable commodity money from Wall Street to the man in the street.

If the Federal Reserve decided to use leading indicators (e.g. commodities) instead of trailing indicators (e.g. the Consumer Price Index, CPI) to fight inflation, or decided to go to a *de facto* commodity index or back to the gold standard, and stopped bad practices such as "printing" dollars to swap for dubious real estate securities, we would not need to otherwise use commodities for monetary purposes. If the Federal Reserve or the European Central Bank prove incable of providing a stable currency, commodity money will provide the long-term stability that our floating currencies since 1970 have usually not exhibited. The more governments try to fight the use of commodities for monetary purposes, the more painful the effects of poorly managed floating currencies will be, and the more painful the resulting transition from those floating currencies to commodity money will be.

Posted by Nick Szabo at 10:40 AM

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6 comments:

Anonymous said...

The last (?) attempt to return to the gold standard was a bit disastrous. Discuss.

12:47 AM

nick said...

anonymous, you are probably referring to the attempt by European national governments, practically bankrupt after WWI, to return to the gold standard, often at pre-WWI levels, while they and others tried to pay the interest on the debts (and Germany tried to pay its war reparations) with the deflated currency. The problem here was not the gold standard, it was war debts beyond the ability of taxpayers to pay (causing governments to go off gold during WWI and later causing taxation higher than the Laffer maximum, which *lowered* tax revenues and made the situation even worse) and a massive *deflation* that Britain for example felt was needed to get back to the pre-WWI standard.

The U.S. Federal Reserve colluded with Britain in this regard, causing destructive deflation in the U.S. At the time of the October stock market crash, the real Fed funds rate was an extraordinary 14%: 6% + an 8% deflation rate. Today, the real rate is probably negative. The Fed itself seems to be subject to great mood swings.

The extreme debts wracked up during the war, the war inflation, and the subsequent forced deflation were all big mistakes. Using inflation during the war as a hidden tax had already destroyed the integrity of the gold standard. It was too late to return to the pre-war exchange rate of pounds for gold -- they should have chosen a new exchange rate reflecting the inflation. Both the war inflation and the subsequent forced deflation seriously screwed up price signals and wreaked havoc on debt contracts.

Along with the extreme deflation caused by attempting to reverse the entire massive war inflation, it was Germany, Austria, Britain and a bunch of other countries defaulting on their debts, coming *off* the gold standard (a de facto default), or both,and the resulting massive gold flow into the U.S., and the idiocy of the Federal Reserve to sterilize this flow to maintain the deflation, that turned a recession into the Great Depression. There were also massive tax hikes in the U.S., Hoover using his Big Stick to promote wage stickiness which caused excess layoffs, Hoover and then FDR throwing up barriers to markets in farm produce, and other problems that also helped cause and prolong the Depression. To pin it on the gold standard itself is a red herring: civilization had been using gold for thousands of years without a Great Depression.

11:13 AM

Clayton said...

Nick: So, I have a question in light of this. I think you're one of the few people that are calling this correctly - rising commodity prices are not a bubble, they're the consequence of an major expansion of the money supply.

That said, I'm conflicted on what to do to protect my cash. I don't have a lot of savings, but I feel that what little I have is daily being eroded. To protect it, I could move it into gold, oil or the market but each option seems frightening. Gold has doubled in price since 2 1/2 years ago, but the money supply has not doubled since then, so there does seem to be some "bubble" in the headline price of gold. If I move my money into gold today, that bubble could burst and I will have a net decrease in the purchasing power (real value) of my savings. Same with oil commodities. The market is equally scary because you're right that this is not just a bubble. There is no rational reason to expect market growth under rapid expansion of the money supply - savings left in commodities is safer than money invested.

Argh. Any thoughts?

11:34 AM

Anonymous said...

Thanks for your discussion. On one point, massive debts are almost invariably run up in wars: it's the nature of the beast. They don't come cheap. Inflation follows from that. . .

10:24 PM

nick said...

n.b.: if anybody would like good customized financial advise, I am available as a consultant at reasonable rates. Meanwhile, here is a free sample of some generalized financial opinions:

Clayton:
To protect it, I could move it into gold, oil or the market but each option seems frightening. Gold has doubled in price since 2 1/2 years ago, but the money supply has not doubled since then, so there does seem to be some "bubble" in the headline price of gold.

There is, alas, no safe place to put your money, and even less is the money itself safe. As some wag recently put it, "the Federal Reserve has turned us all into speculators."

Precious metals, oil, and to a lesser extent other commodities move based on *expectation* of *future* money supply moves, not just on today's money supply. That makes them more volatile than changes in today's money supply. That's also why exchange rates for floating currencies are so volatile. Indeed, it is profitable to think of oil, gas, and precious metals prices as just another set of currency exchange rates. Even with great geological ignorance we can be far more certain about future supplies of these commodities than of future supplies of floating currencies.

We've just gone through a period of the 1980s and 1990s where floating currencies behaved well, and most investors concluded that the 1970s was a fluke. We now see the 1970s being repeated in terms of increasing money supply and other risky central bank behavior. It now appears that 1970s-style inflation, and dangers of hyperinflation, may now be just as normal under floating currencies as the placid 80's and 90's. So the recent commodity rise reflects not just the increase in money supply over demand but the increased expectations for future such increases. Follow the link above labelled "a small change in inflation expectations can cause a very large change in commodity prices" for more explanation of this.

For the small investor I suggest three main possibilities for hedging savings accounts or bonds in floating currencies:

(1) Commodity index ETFs. Any good online brokerage should be allowing you to buy these just like you'd buy shares in stock. There is however some political risk that the expenses of these funds will be substantially increased by new legislation over the next year or two, so keep tabs on their expenses. Also, given the great uncertainties involved in guessing future inflation, these commodity baskets will be very volatile (either up or down) and I don't reject a strong possibility that some of the price reflects a bubble. Bubbles tend to occur in conditions of high uncertainty, whether it was uncertainty about the dot-com revolution, lack of knowledge about the moral hazard in real estate securitization, or today's high uncertainty about future inflation. For the same reason though, commodities may still be undervalued. Bottom line is that their prices will change far more quickly up or down than the consumer prices of most things you will want to buy with your savings, but since they tend to change in the same direction they are useful for hedging future inflation.

(2) Gold or silver coins. I am normally not a gold bug, but I have a hunch precious metals may be a bit undervalued right now: central banks have been dampening the market by selling more of it, and the retail gold ads that were popular a few months ago are mostly gone today, relieving my worries about a gold bubble. Today's political risks are now focused on consumable commodity markets and they will probably leave gold alone. Indeed, a law shutting down pension fund etc. investment in consumable commodities might greatly boost the price of gold and silver, as they would be the main alternative for the funds to invest in to get the same kind of anti-correlative hedge for their bond positions.

(3) If you can afford it without a risky loan, foreclosed or otherwise distressed real estate, in areas where foreclosures are not above the average and where people don't have long commutes to work.

I don't recommend putting most of your assets "long" in any of the above: they are there to hedge your long dollar positions, or somewhat equivalently to replace about a third of your dollar savings accounts or bonds; i.e. money that you are likely to spend in less than three years.

If you are saving money to be spent farther into the future, most of your savings should be in stocks, real estate, and collectibles, with well over half of that in stocks. Even if you have, say, just $500 of long-term savings it should be long a stock index ETF. If you have enough money to pick your own diversified portfolio of individual stocks, for U.S. stocks I suggest heavy exporters (including many Internet and other companies providing services to overseas customers): they profit from a relatively weak dollar.

12:39 PM

runeks said...

Thank you for this very insightful post. I've been having the same thoughts myself, but you've formulated them a lot better than I can.

In looking at the price of commodities (and, indeed, of all things) it seems to me that we've overlooking - as you explain - the currency in which the price is denominated.

I keep getting the image in my head of people running around measuring things using a yard stick. They simply don't understand why the same things seem to grow and shrink in size, seemingly at random. Upon further investigation, it turns out that the same things were actually the same size all along, but it was the definition of the yard that was changing.
The Yard Defining Authority (YDA) kept changing the definition of a yard because it claimed that this would alleviate the issue of measurements changing as the measured objects changed in size. People simply couldn't cope with these ever-changing measurements, the YDA claimed, so it targeted a certain basket of objects (the average height of human beings, the average height of buildings, the average distance travelled by each person per day) to always average to the same length. This, they said, would stop the confusing changes in these measurements, and provide greater value to the yard.
(In case my metaphor doesn't play out as well as it did in my head: the yard is the currency, and the Yard Defining Authority is the central bank)

7:06 AM

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